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IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

No. 174

RUPERT H. JOHNSON, R. H. JOHNSON & CO., and R. H. JOHNSON & CO., INC., *Petitioners*,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT.

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To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit, entered in the above-entitled case on April 5, 1956.

OPINIONS BELOW

The findings and opinion of the Securities and Exchange Commission appear at page 1209 of the Joint Appendix. The opinion of the Court of Appeals (not yet reported) is attached as Appendix A.

JURISDICTION

The judgment of the Court of Appeals was entered on April 5, 1956. A copy of the judgment is attached as Appendix B. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254 (1).

QUESTION PRESENTED

Whether the Securities and Exchange Commission may properly revoke the registration of petitioners —dealers long engaged in the securities business— upon the basis of findings of prior misconduct concerning which no evidence was taken and which petitioners had no opportunity to challenge, rebut or explain.

STATUTES INVOLVED

The statutes involved are the Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a); the Securities Exchange Act of 1934, §§ 10 and 15, 15 U.S.C. §§ 78j and 78o, and the Administrative Procedure Act, §§ 7 and 10, 5 U.S.C. §§ 1006 and 1009.

STATEMENT

By an order dated November 16, 1955, the Securities and Exchange Commission revoked the registrations of the partnership known as R. H. Johnson & Co., (the Firm), and the corporation known as R. H. Johnson & Co., Inc., (the Corporation), as brokers and dealers

in securities. The Commission also found R. H. Johnson, individually, a cause of such revocation. Securities Exchange Act of 1934, § 15(b), 15 U.S.C. § 78o(b). There actions were taken after a hearing, the adequacy and fairness of which is the sole issue presented here.

R. H. Johnson, the controlling figure in the Firm and Corporation bearing his name, has been engaged in the securities business for 33 years and has operated his present business for 28 years. On November 28, 1952, the Commission initiated proceedings against Johnson, the Firm, and the Corporation. These proceedings were later expanded to include four salesmen and two branch managers.

The Commission alleged that the individual salesmen had induced certain customers of the Firm to engage in securities transactions of relatively excessive size and frequency in relation to the nature of their accounts, and that the Firm obtained profits not disclosed to such customers, in violation of the anti-fraud sections of the securities laws.[1] Hearings were held before a Hearing Examiner, and the matter was then argued to the Commission. On November 16, 1955, the Commission issued the opinion and order complained of here. In this opinion it held that the four salesmen in question had in fact dealt with six customers in an unfair manner and had taken advantage of the inexperience of the customers in securities matters to induce the customers to engage in trading beyond what was reasonable and proper in

[1] Section 17 of the Securities Act of 1933, 15 U.S.C. § 77q and Sections 10 and 15 of the Securities Exchange Act of 1934, 15 U.S.C. 78j and 78o and Rules X-10B-5 and Rules 10-15C1-2 thereunder.

the light of the needs of the customers.[2] The Commission held that this action by the salesmen was a violation of the anti-fraud provisions of the securities laws cited above and that the Firm was responsible for the violations. It also held that R. H. Johnson, the dominant partner in the Firm, was responsible for the misconduct of the salesmen because he had failed to insure adequate supervision of the activities of the salesmen. No individual guilt on the part of R. H. Johnson was found and no misconduct or participation in the misconduct of the four salesmen was charged against Johnson individually. The basis for the finding against him was that he had failed adequately to supervise the salesmen in question.

The Commission on the basis of this conclusion revoked the Firm's right to do business and entered an order which if effective would exclude the Firm and any firm with which R. H. Johnson personally may be connected from the business of engaging in the purchase and sale of securities.

R. H. Johnson and Company was a very large firm with many branch offices, over 100 salesmen and between four and five thousand active customer accounts (J.A. 96, Johnson Exhibit No. 18). The violations in question related to the activities of only four of the salesmen in relation to six of the accounts. None of the salesmen were in the employ of the Firm at the time the Commission's order was entered, nor had they been for some time (Johnson Exhibit 18; Affidavit of Johnson, J.A. 20).

[2] It was also held that because of the relation of trust and confidence which it was found had been established between the salesmen and the customers in question, that the salesmen were under obligation to advise the customers of the profits made by the firm on some of the transactions and that they had failed to do so.

This drastic penalty—revocation of the right to do business because of failure to supervise four former salesmen in their dealings with a small fraction of the accounts of the firm—was a disproportionately severe punishment if the offense had been a first offense. Cf. *Bond & Goodwin, Inc.*, 15 S.E.C. 584 (1944); Loss, *Securities Regulation*, pp. 739-740 (1951). However, the Commission did not regard the situation as though it were a first offense. Its discussion of the subject of the revocation commences with an allegation relating to prior misconduct and prior disciplinary action. The first paragraph of the Commission's opinion under the heading "The Public Interest" reads as follows:

> "The Public Interest—
>
> "Under the provisions of the Exchange Act here applicable, we may revoke registrant's registration if we find it in the public interest. This is not the first time that disciplinary action has been taken against registrant. Registrant was expelled from membership in the NASD for inducing the excessive trading in the E account, and in our opinion sustaining the expulsion we cited previous sanctions imposed on registrant by the NASD and the New York Stock Exchange." (J.A. 1236).

The Commission then recites that "under all the circumstances" cited, including the alleged prior misconduct, revocation is appropriate.

It is not contested, however, that the record upon which the Commission rested its decision contained not so much as one syllable of testimony concerning the alleged prior misconduct and prior disciplinary action. During the course of procedings before the Hearing

Examiner, the Commisson's staff counsel stated his intention of producing witnesses who would testify as to prior misconduct and prior disciplinary action. He stated:

> "Mr. Reid: This evidence is offered primarily for one reason, that the Commission in the event it does find that the respondent has violated the particular fraud sections which are the essence of this case, we must consider whether it is in the public interest to revoke the registration of the respondent for such violations.
>
> "It is believed that this proof is material for such consideration and determination by the Commission * * *." (J.A. 888.)

Petitioners' counsel objected on the ground that such evidence would be appropriate only after a finding of violation. The Hearing Examiner ruled that such evidence would be proper, but the question being in doubt in his mind, referred the matter to the Commission. The intended witnesses were excused and no testimony was taken (J.A. 893 to 894). The Commission reversed the Hearing Examiner's ruling and held that the proffered proof was not admissible (J.A. 1139-1140). Accordingly, no testimony was taken on the subject of alleged prior misconduct or prior disciplinary action. The Hearing Examiner thereafter issued a recommended decision finding violations by the salesmen and holding the firm responsible but recommending leniency (J.A. 1201). His decision was not in any part based on any alleged prior misconduct. The record was never reopened by the Commission to produce any witnesses to testify about the alleged prior misconduct. Accordingly, the record is barren of any evidence on the subject of prior misconduct.

It was in this condition at the time the Commission on November 16, 1955, announced its judgment.

Yet the Commission's opinion was based upon the supposed prior misconduct. It cites no other basis for the order of revocation, being confined on this point to a recital of the previous "disciplinary action" and "sanctions" imposed on the Firm, and a rejection of certain circumstances offered in mitigation (J.A. 1236-1238).

The Commission's order was further extraordinary in that although respondents had been in business, as stated, for 28 years and Mr. Johnson for 33 years, the order was made immediately effective. It was only on being advised that petitioners had applied to the Court of Appeals for a stay that the Commission allowed ten days for that Court to consider the matter. It vigorously opposed a stay before the Court of Appeals pending appeal and has since opposed all stays granted by that Court. Thus had it not been for the application to the Court of Appeals, it would have been necessary for R. H. Johnson & Co. to close its doors immediately, after many years of business and suddenly to throw its many employees out of work.

This course of conduct and the vigor of the Commission's position can be explained only on the basis of its statement in its opinion that it believed it was dealing with a confirmed violator. This despite the fact that no evidence to that effect appears in the record.

The Court of Appeals affirmed the Commission's finding by opinion and judgment dated April 5, 1956, and this petition followed.

REASONS FOR GRANTING THE WRIT

1. As appears from the statement of facts, a severe penalty has been meted out to petitioners by an order of the Securities and Exchange Commission sanctioned by the Court of Appeals. This penalty, if affirmed, will result in the loss of a business of many years' standing and exclusion of petitioner Johnson from his lifelong occupation. The order is explicitly based upon an assumption by the Commission that it was dealing with parties with a long previous record of disobedience. Yet, that finding was made on a record which contained no evidence whatever with respect to this vital assumption. This is such a clear departure from the accepted course of judicial or administrative proceedings that it calls for the exercise of this Court's power of supervision. It is in direct conflict with the holdings of this Court and of other courts of appeals.

Petitioners agree that the Commisson has the right to consider evidence of past misconduct in seeking to determine what would be an appropriate penalty to be visited upon petitioners for violations found. What the Commisson did here, however, was to consider and give weight to such evidence *without making it a part of the record, without notice to the parties,* and *without giving petitioners any opportunity to challenge, explain or rebut it.* Precisely such procedure was condemned by this Court in *Ohio Bell Telephone Co.* v. *Public Utilities Comm.*, 301 U.S. 292. In that case the Public Utilities Commisson held hearings to fix rates for the telephone company. After the hearings were closed and without warning, the Commission revealed in its report that it had taken judicial notice of price trends, not in evidence, to aid in determining

appropriate rates. This Court held the Commission's order void for the following reasons:

> "* * * Without warning or even the hint of warning that the case would be considered or determined upon any other basis than the evidence submitted, the Commission cut down the values for the years after the date certain upon the strength of information secretly collected and never yet disclosed. The company protested. It asked for disclosure of the documents indicative of price trends, and an opportunity to examine them, to analyze them, to explain and to rebut them. The response was a curt refusal. . . . This is not the fair hearing essential to due process. It is condemnation without trial.
>
> "An attempt was made by the Commission and again by the state court to uphold this decision without evidence as an instance of judicial notice . . . . notice even when taken, has no other effect than to relieve one of the parties to a controversy of the burden of resorting to the usual forms of evidence. . . . 'It does not mean that the opponent is prevented from disputing the matter by evidence if he believes it disputable.' Ibid. * * *" (301 U.S. 300-302.)

Procedure such as that upheld by the Court of Appeals was also condemned by this Court's holdings in *United States* v. *Abilene and So. Ry. Co.*, 265 U.S. 274 and *Morgan* v. *United States*, 304 U.S. 1. In *Abilene*, this Court declared that "nothing can be treated as evidence which is not introduced as such." 265 U.S. 288.[3]

The ruling of the court below is also in direct conflict with the decision of the Sixth Circuit Court of Appeals

[3] These two cases were recently approved by the Court in *Gonzales* v. *United States*, 348 U.S. 407, 413, 414.

in *Powhatan Mining Co.* v. *Ickes*, 118 F. 2d 105 (C.A.A. 6, 1941). There the court pointed out that the broader the power of an agency to notice facts outside the record, "the more scrupulous should be the effort on the part of the agency to extend to the litigant the right to test evidence thus admitted by the fullest possible cross-examination." (118 F. 2d at 110).

The procedure utilized here by the Commission was expressly condemned in the *Final Report of the Attorney General's Committee on Administrative Procedure* (1941). It was there said that whenever facts are judicially noticed the parties "are entitled not only to refute, but, what in this situation is usually more important, to supplement, explain and give different perspective to the facts on which the agency relies." (P. 72).[4]

Section 7(d) of the Administrative Procedure Act, 5 U.S.C. § 1006, specifically provides that:

> "The transcript of testimony and exhibits, together with all papers and requests filed in the proceeding, shall constitute the exclusive record for decision in accordance with section 8 . . . Where any agency decision rests on official notice of a material fact not appearing in the evidence in the record, any party shall on timely request be afforded an opportunity to show the contrary."

This section makes clear that parties to proceedings are entitled to answer any facts considered by the agency outside the record by means of official notice.

[4] See also Note, "*The Relationship of Official Notice to the Substantial-Evidence Rule in the Judicial Review of Administrative Adjudications*," 60 Harv. L. Rev. 620 (1947); Gellhorn, *Administrative Law*, pp. 553-601 (1947); Davis, *Administrative Law*, p. 476, et seq. (1951).

Yet, no opportunity was given to these petitioners to meet the allegations of prior misconduct relied upon by the Commission in imposing the severe penalty of revocation.

Indeed, as we have seen, at the hearing before the Commission a proffer of evidence of prior misconduct was excluded by a ruling of the Commission itself. This made it unnecessary for plaintiffs to meet or explain this allegation. Further, the Hearing Examiner's initial decision placed no reliance on alleged prior misconduct. *The petitioners had no intimation that supposed prior misconduct was to be considered before the Commission issued its final order, effective immediately, on November 16, 1955.*

The procedure used by the Securities and Exchange Commission in the present case was a clear denial of the basic elements of a fair hearing. Due process of law embraces not only the right to present evidence but also an opportunity to meet and answer the claims of the opposing side. *Morgan* v. *United States, supra*, at p. 18 of 304 U.S. Here the petitioners got no hearing at all on facts which turned out to be crucial to the result of their case. This Court should not permit such a flagrant departure from its accepted rulings.[5]

2. Before the Court of Appeals, the Securities and Exchange Commission did not deny (as it could not) that its decision was based on the alleged prior misconduct of petitioners. It did not deny that the record contains no evidence of such alleged prior misconduct.

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[5] ". . . Fastidious regard for the honor of the administration of justice requires the Court to make certain that the doing of justice be made so manifest that only irrational or perverse claims of its disregard can be asserted." *Communist Party* v. *Subversive Activities Control Board*, ——— U.S. ———, April 30, 1956.

It did not defend the propriety of making a decision based on evidence not in the record. Instead, in the Court below, its counsel made two technical defenses designed to suggest that petitioners had no right to raise this question of fundamental denial of due process. These technical objections are afterthoughts of counsel, not mentioned in the Commission's opinion, and, in addition, are clearly without merit.

(A) It was suggested by the Commission counsel that the issue of previous misconduct is *res judicata*. They relied on a previous proceeding involving disciplinary action by the National Association of Securities Dealers against petitioner, relating to one of the salesmen and one of the accounts also involved in the present proceedings.

Fundamentally this plea must fail because the Commission gave no notice in the record that it intended to rely on the previous proceedings as *res judicata*. As this Court has stated, *res judicata* is applicable only where the previous judgment alleged to be *res judicata* is pleaded as such. *United States* v. *Bliss*, 172 U.S. 321, 326, states:

> "If a party neither pleads nor proves what has been decided by a court of competent jurisdiction in some other case between himself and his antagonist, he cannot insist upon the benefit of res judicata, and this although such prior judgment may have been rendered by the same court."

By failing to advise petitioners that it intended to rely on the previous proceedings in this case, the Commission denied the petitioner an opportunity (a) to argue that the issue was not *res judicata*, as it clearly

was not,[6] and (b) to bring in evidence to establish that the alleged prior misconduct was either not misconduct or was of such a character or occurred so long ago as to be irrelevant to the issue of a present penalty. By bringing up the *res judicata* question in the courts as an afterthought, counsel seeks to aggravate the effect of denial to petitioners of an opportunity to refute the charge of prior misconduct.

(B) The other technical defense of the Commission is a claim that petitioner was required to seek a rehearing before raising the issue of the Commission's erroneous reliance on unproved prior misconduct. This contention runs counter to the Administrative Procedure Act and to the decisions of this Court, which establish that an application for rehearing is not a necessary prerequisite to judicial review. The court review section of the Administrative Procedure Act, § 10(c), 5 U.S.C. § 1009(c), provides:

> "Except as otherwise expressly required by statute, agency action otherwise final shall be final for the purposes of this subsection whether or not there has been presented or determined any application for a declaratory order, for any form of reconsideration, or (unless the agency otherwise requires by rule and provides that the action meanwhile shall be inoperative) for an appeal to superior agency authority."

[6] The issues in the earlier proceeding were not identical to those here. In that proceeding the question was whether or not a penalty imposed by the National Association of Securities Dealers was excessive. In the present case the issue was what remedy should be imposed in the public interest, under the circumstances shown, to prevent future violations of law. Petitioners claim the right to be heard on the significance to be attached to the earlier proceeding, not an opportunity to dispute the existence of that proceeding.

Thus, an application for rehearing was unnecessary unless specifically required by statute.

The Securities Exchange Act of 1934, § 25, 15 U.S.C. § 78(y), unlike certain other statutes[7] does not require a petition for rehearing as a prerequisite to court review.[8]

But even had there been such a statutory provision, the Commission denied petitioners any opportunity to seek a rehearing. For, as we have seen, the Commission made its order effective immediately and opposed any stay. If petitioner had sought a rehearing, it would have suffered the sanction of being put out of business in the meantime. Plainly, petitioner was compelled to go to court to prevent closing its doors. Commission counsel here claims for the Commission the power immediately to destroy a substantial firm of many years' standing and cause the dismissal of its many employees, and yet to deny that firm access to the courts pending the filing and consideration of a petition for rehearing before the Commission. No such power exists.

Plainly, if the Commission intends to assert a right to have matters presented to it by petition for rehearing, it must withhold its sanction to permit persons subject to its jurisdiction to avail themselves

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[7] E.g., Natural Gas Act, 15 U.S.C. § 717r(a); Federal Power Act, 16 U.S.C. § 825*l*(g).

[8] Of course, as previously stated, the petitioner had objected vigorously to the use of evidence respecting prior violations when an attempt was made to introduce this evidence at the hearing. This objection was sustained by the Commission. A petition for rehearing could have served no purpose other than to reiterate a position previously stated by petitioners and accepted by the Commission in the proceedings.

of that right without losing their business in the interim. This is the teaching of the rulings of this Court. *United States* v. *Abilene & So. Ry. Co.*, 265 U.S. 274, 280-282; *Prendergast* v. *N. Y. Tel. Co.*, 262 U.S. 43, 48; *Levers* v. *Anderson*, 326 U.S. 219.

CONCLUSION

Petitioners in this case have been put out of business by an order of an administrative agency, which bars petitioner Johnson from the occupation in which he has been engaged for 33 years. In such circumstances this Court has decreed that agency proceedings must adhere meticulously to the standards of fairness embodied in the concept of due process of law.

The Securities and Exchange Commission did not give petitioners a fair hearing in this case. Instead, the Commission relied upon evidence never introduced into the record and as to which petitioners had no knowledge until the hearing was closed and the Commission's final order became effective. This is such a clear defiance of the repeated rulings of this Court as to call for the exercise of its supervisory power.

For the foregoing reasons, this petition for certiorari should be granted.

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